

Office of the State Auditor

Division of State Audit

Office of State Treasurer Bismarck, North Dakota

Audit Report for the
Biennium Ended June 30, 2007
Client Code 120

Robert R. Peterson
State Auditor



LEGISLATIVE AUDIT AND FISCAL REVIEW COMMITTEE MEMBERS

Representative Bob Skarphol – Chairman
Senator Randel Christmann – Vice Chairman

Representatives

Ole Aarsvold
Larry Bellew
Merle Boucher
Kari L. Conrad
Jeff Delzer
Bette Grande
Patrick R. Hatlestad
RaeAnn G. Kelsch
Kenton Onstad
Louis Pinkerton
Blair Thoreson
Francis J. Wald

Senators

Dwight Cook
Jerry Klein
Judy Lee
Harvey D. Tallackson

You may obtain reports by contacting the
Division of State Audit
at the following address:

Office of the State Auditor
600 East Boulevard Avenue – Department 117
Bismarck, ND 58505-0060
(701) 328-2241

Reports are also available on the internet at:
www.nd.gov/auditor/

Contents

<i>Transmittal Letter</i>	<i>1</i>
<i>Executive Summary</i>	<i>2</i>
<i>Introduction</i>	<i>2</i>
<i>Responses to LAFRC Audit Questions</i>	<i>2</i>
<i>LAFRC Audit Communications</i>	<i>3</i>
<i>Audit Objectives, Scope, And Methodology</i>	<i>5</i>
<i>Management’s Discussion And Analysis</i>	<i>7</i>
<i>Financial Summary</i>	<i>7</i>
<i>Analysis of Significant Changes in Operations</i>	<i>7</i>
<i>Financial Statements</i>	<i>10</i>
<i>Statement of Revenues and Expenditures</i>	<i>10</i>
<i>Statement of Appropriations</i>	<i>11</i>
<i>Internal Control</i>	<i>13</i>
<i>Coding and Approval Controls Weakness</i>	<i>14</i>
<i>Control Environment</i>	<i>16</i>
<i>Control/Fraud Risk Assessment Activities</i>	<i>17</i>
<i>Compliance With Legislative Intent</i>	<i>18</i>
<i>Coal Severance Tax Distribution</i>	<i>20</i>
<i>Oil and Gas Tax Distribution</i>	<i>21</i>
<i>Estate Tax Distribution</i>	<i>22</i>
<i>Operations</i>	<i>25</i>
<i>Prior Recommendations Not Implemented</i>	<i>26</i>
<i>Coal Severance Tax Distribution</i>	<i>26</i>
<i>Oil and Gas Production Tax Distribution</i>	<i>27</i>
<i>Management Letter (Informal Recommendations)</i>	<i>28</i>

Transmittal Letter

April 30, 2008

The Honorable John Hoeven, Governor
Members of the North Dakota Legislative Assembly
The Honorable Kelly Schmidt, State Treasurer

We are pleased to submit this audit of the Office of State Treasurer for the biennium ended June 30, 2007. This audit resulted from the statutory responsibility of the State Auditor to audit or review each state agency once every two years. The same statute gives the State Auditor the responsibility to determine the contents of these audits.

In determining the contents of the audits of state agencies, the primary consideration was to determine how we could best serve the citizens of the state of North Dakota. Naturally we determined financial accountability should play an important part of these audits. Additionally, operational accountability is addressed whenever possible to increase efficiency and effectiveness of state government.

The in-charge auditor for this audit was Michael W. Schmitcke, CPA. Andrea Wike and Paul Deede were the staff auditors. Cindi Pedersen, CPA was the audit supervisor and Paul Welk, CPA, was the audit manager. Inquiries or comments relating to this audit may be directed to the audit manager by calling (701) 328-2320.

Respectfully submitted,

Robert R. Peterson
State Auditor

Executive Summary

INTRODUCTION

The Office of State Treasurer receives and keeps all the monies belonging to the state not required to be received or kept by another state entity. The Office of State Treasurer is responsible for the investment of certain special funds, as well as several trust funds, including the Veteran's Postwar Trust Fund.

RESPONSES TO LAFRC AUDIT QUESTIONS

The Legislative Audit and Fiscal Review Committee (LAFRC) requests that certain items be addressed by auditors performing audits of state agencies.

1. What type of opinion was issued on the financial statements?

Financial statements were not prepared by the Office of State Treasurer in accordance with generally accepted accounting principles so an opinion is not applicable. The agency's transactions were tested and included in the state's basic financial statements on which an unqualified opinion was issued.

2. Was there compliance with statutes, laws, rules, and regulations under which the agency was created and is functioning?

Other than our findings addressing "coal severance tax distribution" (page 20); "oil and gas production tax distribution" (page 21); and "estate tax distribution" (page 22); the Office of State Treasurer was in compliance with significant statutes, laws, rules, and regulations under which it was created and is functioning.

3. Was internal control adequate and functioning effectively?

Other than our findings addressing "coding and approval controls weakness" (page 14), "control environment" (page 16), and "control/fraud risk assessment activities" (page 17), we determined internal control was adequate.

4. Were there any indications of lack of efficiency in financial operations and management of the agency?

No.

5. Has action been taken on findings and recommendations included in prior audit reports?

Other than our recommendations noted on pages 26-27, the Office of State Treasurer has implemented all recommendations included in the prior audit report.

6. *Was a management letter issued? If so, provide a summary below, including any recommendations and the management responses.*

Yes, a management letter was issued and is included on page 28 of this report, along with management's response.

LAFRC AUDIT COMMUNICATIONS

1. *Identify any significant changes in accounting policies, any management conflicts of interest, any contingent liabilities, or any significant unusual transactions.*

There were no significant changes in accounting policies, no management conflicts of interest were noted, no contingent liabilities were identified or significant unusual transactions.

2. *Identify any significant accounting estimates, the process used by management to formulate the accounting estimates, and the basis for the auditor's conclusions regarding the reasonableness of those estimates.*

The Office of State Treasurer's financial statements do not include any significant accounting estimates.

3. *Identify any significant audit adjustments.*

Significant audit adjustments were not necessary.

4. *Identify any disagreements with management, whether or not resolved to the auditor's satisfaction relating to a financial accounting, reporting, or auditing matter that could be significant to the financial statements.*

None.

5. *Identify any serious difficulties encountered in performing the audit.*

None.

6. *Identify any major issues discussed with management prior to retention.*

This is not applicable for audits conducted by the Office of the State Auditor.

7. *Identify any management consultations with other accountants about auditing and accounting matters.*

None.

8. *Identify any high-risk information technology systems critical to operations based on the auditor's overall assessment of the importance of the system to the agency and its mission, or whether any exceptions identified in the six audit report questions to be addressed by the auditors are directly related to the operations of an information technology system.*

ConnectND Finance, Human Resource Management System (HRMS), Oil and Gas Production Tax Distribution System, State Aid Distribution System, Highway Tax Distribution System, Coal Conversion Tax Distribution System, Township Road and Bridge Fund Distribution System, Coal Severance Tax Distribution, and Estate Tax Distribution are high-risk information technology systems critical to the Office of State Treasurer.

Audit Objectives, Scope, And Methodology

Audit Objectives

The objectives of this audit of the Office of State Treasurer for the biennium ended June 30, 2007 were to provide reliable, audited financial statements and to answer the following questions:

1. What are the highest risk areas of the Office of State Treasurer's operations and is internal control adequate in these areas?
2. What are the significant and high-risk areas of legislative intent applicable to the Office of State Treasurer and are they in compliance with these laws?
3. Are there areas of the Office of State Treasurer's operations where we can help to improve efficiency or effectiveness?

Audit Scope

This audit of the Office of State Treasurer is for the biennium ended June 30, 2007. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The Office of State Treasurer's sole location is its central office which will be included in the audit scope.

Audit Methodology

To meet the objectives outlined above, we:

- Prepared financial statements from the legal balances on the state's accounting system tested as part of this audit and the audit of the state's Comprehensive Annual Financial Report and reviewed management's discussion and analysis of the financial statements.
- Performed detailed analytical procedures including computer assisted auditing techniques. These procedures were used to identify high risk transactions and potential problem areas for additional testing.
- Tested internal control and compliance with laws and regulations which included selecting representative samples to determine if controls are operating effectively and to determine if laws are being followed consistently. Nonstatistical sampling was used and the results were projected to the population. Where applicable, populations were stratified to ensure that particular groups within a population are adequately

represented in the sample, and to improve efficiency by gaining greater control on the composition of the sample.

- Interviewed appropriate agency personnel.
- Queried the ConnectND (PeopleSoft) ERP system. Given the complexity of the state's accounting system, significant evidence was obtained from ConnectND.
- Observed the Office of State Treasurer's processes and procedures.

In aggregate, there were not any significant limitations or uncertainties related to our overall assessment of the sufficiency and appropriateness of audit evidence.

Management's Discussion And Analysis

The accompanying financial statements have been prepared to present the Office of State Treasurer's revenues and expenditures on the legal (budget) basis. The accompanying financial statements are not intended to be presented in accordance with generally accepted accounting principles (GAAP).

The following management discussion and analysis was prepared by the Office of State Treasurer's management. We have applied certain limited procedures, which consisted primarily of inquiries of management regarding the methods of measurement and presentation of this supplementary information to ensure it does not conflict with the knowledge we gained as part of our audit.

For the biennium ended June 30, 2007, operations of the Office of State Treasurer were funded by appropriations from the state's general fund.

FINANCIAL SUMMARY

Revenues consist primarily of "transfers in" of tax dollars collected by the state and then distributed by the Office of State Treasurer. Other revenues include the Bank of North Dakota and the North Dakota Mill profits, royalties, fees, and interest income. The most significant increases in revenue from fiscal year 2006 and 2007 were from transfers in and interest earnings. The increase in transfers is attributed to increased oil drilling operations in North Dakota as well as the increased value of oil. Interest and investment income to the state were up due to improved cash management practices, increases in interest rates, and the growing cash balance due to the strong economic position North Dakota has experienced in the last several years. Total revenues were \$284,735,509 for the year ended June 30, 2007 as compared to \$187,473,194 for the year ended June 30, 2006.

Expenditures represent the distribution of state dollars to political subdivisions and transfers out. Total expenditures for the Office of State Treasurer were \$493,837,896 for the year ended June 30, 2007 as compared to \$482,434,970 for the year ended June 30, 2006.

ANALYSIS OF SIGNIFICANT CHANGES IN OPERATIONS

BidND

Certificates of deposit (CD's) are purchased from North Dakota community financial institutions which lend these dollars back into their communities, fostering economic

growth. As of June 30, 2007, approximately \$4 million have been invested in CD's throughout the state.

New Website

Tax distributions and BidNd investments are now available on our website. This tool has helped those we serve; auditors, state agencies, legislators, and the general public, by giving them access to information without delay. It has brought transparency to the distribution process, as well as, efficiencies in time and resources all while increasing our productivity. Finally, the website has helped us educate our stakeholders as to our agency functions.

Investment Returns

During the 2005-07 biennium North Dakota experienced unprecedented revenue growth. Our office is proud to have participated in this growth by depositing over \$36.5 million in interest income to the general fund. This represents \$30 million more than the prior biennium. We have also experienced excellent returns for the state's agricultural commodity groups, the Veteran's Postwar Trust Fund, and other various trust funds under our purview.

Fraud Prevention

The state of North Dakota has experienced several fraud attempts. These include an internet scam, mortgage scam, and lottery check scam with total check and wire exposure of nearly \$500,000. Due to the excellent efforts of our dedicated staff, the state of North Dakota has experienced no financial loss.

We have worked diligently to improve overall communication. Through communication with other state agencies, political subdivisions, and the financial community we have made advancements and created efficiencies in cash management, customer service, and investment returns.

The following activities were added during the 2005-2007 biennium:

- Eliminated the process of receiving cancelled checks in paper form, check data is now received via compact discs, which can now be processed electronically.
- Conversion of green bar reports to current technology format.
- Cash management achievements include establishing the line of communication with financial officers throughout state government to address the daily cash needs and expenditures

of their agency. This communication is critical in aiding our agency's ability to provide and forecast cash flow.

- Retention of cleared check data has been increased from monthly to annually which allows agencies to research check status electronically. This alleviates the Office of State Treasurer's staff research time.
- Streamlined the agency deposit procedures. This has eliminated the need for manually prepared deposit tickets. We have replaced it with screen prints; this ensures validation and eliminates the potential for errors.
- Developed new database systems.
- Policy and procedure development.
- All employees have been cross trained for at least one other employee's duties.
- Eliminated the printing of the outstanding check register and ACH remittance advice. This has reduced paper, processing, and storage as these documents combined had an average size of 5,000 pages per month.

Financial Statements

STATEMENT OF REVENUES AND EXPENDITURES

	<u>June 30, 2007</u>	<u>June 30, 2006</u>
<u>Revenues and Other Sources:</u>		
BND and ND Mill Profits	\$ 65,000,000	
Interest and Investment Earnings	18,916,558	\$ 9,115,884
Royalties	14,792,276	14,951,126
Fines-Forfeitures-Escheat	7,927,592	7,659,354
Miscellaneous Revenue	3,482,678	3,426,931
Transfers In	174,616,405	152,319,899
Total Revenues and Other Sources	<u>\$ 284,735,509</u>	<u>\$ 187,473,194</u>
<u>Expenditures and Other Uses:</u>		
Salaries and Benefits	\$ 317,840	\$ 313,378
Tax Distributions to Government Units	285,919,321	280,775,664
Jobs Training Expense	2,158,297	2,195,974
Inheritance Tax Refund	190,712	41,718
Major Operating Expenses:		
Fees – Professional Services	50,883	43,311
IT – Data Processing	24,333	43,908
Office Equipment and Furniture under \$5,000	6,698	1,401
Travel	4,895	3,307
Postage	4,464	4,225
IT – Communications	4,077	3,614
Other Operating Expenses	16,467	8,969
Transfers Out	205,139,909	198,999,501
Total Expenditures and Other Uses	<u>\$ 493,837,896</u>	<u>\$ 482,434,970</u>

STATEMENT OF APPROPRIATIONS

For The Biennium Ended June 30, 2007

Expenditures by Line Item:	<u>Original Appropriation</u>	<u>Adjustments</u>	<u>Final Appropriation</u>	<u>Expenditures</u>	<u>Unexpended Appropriation</u>
Salaries and Benefits	\$ 644,760		\$ 644,760	\$ 631,218	\$ 13,542
Operating Expenses	154,787		154,787	142,895	11,892
In Lieu of Tax Payments	1,545,000		1,545,000	1,443,328	101,672
Totals	<u>\$ 2,344,547</u>		<u>\$ 2,344,547</u>	<u>\$ 2,217,441</u>	<u>\$ 127,106</u>
Expenditures by Source:					
General Fund	\$ 2,344,547		\$ 2,344,547	\$ 2,217,441	\$ 127,106
Totals	<u>\$ 2,344,547</u>		<u>\$ 2,344,547</u>	<u>\$ 2,217,441</u>	<u>\$ 127,106</u>

Expenditures Without Appropriations Of Specific Amounts:

Distributions from the General Fund of the Minerals Management Tax, authorized by NDCC 15.1-28-03	\$ 15,785,016
Transfers from the General Fund to the Senior Citizens Services and Programs Fund and the distribution from that fund, authorized by NDCC 57-39.2-26.2 (fund 255)	2,068,043
Jobs Training Fund has a continuing appropriation authorized by NDCC 52-02.1-03 (fund 384)	4,349,187
Highway Tax Distribution Fund, the activity is authorized by NDCC 54-27-19 (fund 400).	347,345,916
State Aid Distribution Fund, the activity is authorized by NDCC 57-39.2-26.1 (fund 401).	83,869,257
Financial Tax Distribution Fund, has a continuing appropriation authorized by NDCC 57-35.3-09 (fund 405).	16,835,844
Veterans Postwar Trust Fund, the activity is authorized by NDCC 37-14-14 (fund 410).	80,973

Coal Severance Tax Fund, the activity is authorized by NDCC 57-61-01 (fund 412).	\$ 23,984,122
Federal Tax Replacement Fund, the activity is authorized by NDCC 15.1-27-24 (fund 416).	749,837
Cigarette Tax Distribution Fund, has a continuing appropriation authorized by NDCC 57-36-31 (fund 420).	2,959,247
Telecommunications Tax Distribution Fund, has a continuing appropriation authorized by NDCC 57-34-05 (fund 424).	16,800,000
Oil and Gas Production Tax Distribution Fund, the activity is authorized by NDCC 57-51-15 (fund 427).	222,515,582
Transmission Line Tax Distribution Fund, the activity is authorized by NDCC 57-33.1-08 (fund 431).	830,979
Township Highway Aid Fund, the activity is authorized by NDCC 54-27-19.1 (fund 444).	10,767,931
Coal Conversion Tax Fund, has a continuing appropriation authorized by NDCC 57-60-14 (fund 454).	56,730,739
Oil Extraction Tax Development Trust Fund, the activity is authorized by NDCC 57-51.1-07 (fund 458).	129,114,530
Estate Tax Fund, the activity is authorized by NDCC 57-37.1-08 (fund 468).	2,556,895
Transfers from the General Fund to the Permanent Oil Tax Trust Fund, the activity is authorized by NDCC 57-51.1-07.2.	34,350,000
Air Transportation Fee Fund, the activity is authorized by NDCC 57-32-04 (fund 494).	293,497
State Taxes Distribution Fund, has a continuing appropriation authorized by Article X, subsection 10, of the Constitution (fund 430).	3,407,763

Internal Control

In our audit for the biennium ended June 30, 2007, we identified the following areas of the Office of State Treasurer's internal control as being the highest risk:

Internal Controls Subjected To Testing

- Controls surrounding the processing of revenues.
- Controls surrounding the processing of expenditures.
- Controls relating to compliance with legislative intent.
- Controls surrounding the ConnectND (PeopleSoft) system.
- Controls surrounding the following information systems:
 - Oil and Gas Production Tax Distribution System;
 - State Aid Distribution System;
 - Highway Tax Distribution System;
 - Coal Conversion Tax Distribution System;
 - Township Road and Bridge Fund Distribution System;
 - Coal Severance Tax Distribution; and
 - Estate Tax Distribution System.

The criteria used to evaluate internal control is published in the publication *Internal Control – Integrated Framework* from the Committee of Sponsoring Organizations (COSO) of the Treadway Commission.

We gained an understanding of internal control surrounding these areas and concluded as to the adequacy of their design. We also tested the operating effectiveness of those controls we considered necessary based on our assessment of audit risk. We concluded that internal control was not adequate - noting certain matters involving internal control and its operation that we consider to be significant deficiencies.

Auditors are required to report deficiencies in internal control that are significant within the context of the objectives of the audit. A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect (1) misstatements in financial or performance information, (2) violations of laws and regulations, or (3) impairments of effectiveness or efficiency of operations, on a timely basis. Considering both qualitative and quantitative factors, we identified the following significant deficiencies in internal control. We also noted other matters involving internal control that we have reported to management of the Office of State Treasurer in a management letter dated April 30, 2008.

CODING AND APPROVAL CONTROLS WEAKNESS

Finding 07-1

Controls surrounding the coding of PeopleSoft transactions and approval of those transactions are inadequate. The State Treasurer's Office is responsible for transferring millions of dollars between funds using account codes developed by the Office of Management and Budget (OMB) which allow for the proper accounting and reporting of these transfers. Although monies were transferred to the correct funds, our audit identified a significant number of transfers for which incorrect transfer codes were used and were not detected by management during the approval process.

Using incorrect transfer codes had the following effects:

- Reports generated from PeopleSoft to determine where funds were transferred to/from do not accurately reflect the transfers for oil and gas tax distributions as well as coal tax distributions;
- Additional analysis and adjustments of the PeopleSoft data related to the transfers incorrectly coded by the Office of State Treasurer must be performed by OMB to ensure compliance with Generally Accepted Accounting Principles during preparation of the state's Comprehensive Annual Financial Report;
- There is an increased risk of material misstatements going undetected by the Office of State Treasurer as the approval function is not operating effectively.

OMB developed account codes in PeopleSoft and through training has instructed agencies to use the proper account codes when recording transactions into PeopleSoft. In addition, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) Internal Control – Integrated Framework defines many different types of control activities including checks for accuracy and authorization of transactions. This framework dictates that control activities such as approval must be performed thoughtfully, conscientiously, and consistently to be effective.

Recommendation:

We recommend the Office of State Treasurer:

- Ensure all transactions recorded on PeopleSoft are coded properly; and
- Develop an approval process that will ensure transactions recorded on PeopleSoft are proper.

Office of State Treasurer Response:

We agree that incorrect transfer codes were used. Our office has implemented additional procedures to track transfer codes as part of the fund balance reconciliation and we will take more care in properly coding and reviewing transfers to ensure coding issues are minimized in the future.

Finding 07-2

CONTROL ENVIRONMENT

The control environment at the Office of State Treasurer has many deficiencies which are primarily related to financial controls and controls surrounding compliance with laws and regulations.

These deficiencies have resulted in accounting errors going undetected, which in a number of instances has led to non-compliance with state laws and regulations and OMB policy. In addition, the lack of these critical controls has resulted in the Office of State Treasurer not performing the oil and gas production tax distribution and coal severance tax distribution in accordance with NDCC for a period of six years. Audit recommendations for each of these distributions will be issued for the 3rd consecutive audit. The recommendation related to the Oil and Gas Production Tax Distribution is on page 21 and the Coal Severance Tax Distribution recommendation is on page 20.

Management of the Office of State Treasurer is responsible for the implementation and monitoring of the internal control functions of the Office. Statement on Auditing Standards (SAS) No. 112 states that an ineffective control environment is a control deficiency in itself and that control deficiencies in other components of internal control may be considered an indication of an ineffective control environment.

Audit Recommendation
and Agency Response

Recommendation:

We recommend the Office of State Treasurer:

- Develop and implement internal controls surrounding critical business functions including compliance with laws and regulations; and
- Monitor internal controls to ensure they are operating efficiently and effectively.

Office of State Treasurer Response:

We agree that the Treasurer's Office has had a long history of control environment issues. This administration has worked with the Auditor's Office and the Office of Management and Budget to address several high risk areas. We have made significant improvements in the areas of Cash Management and Tax Distributions. However, we have not been able to address all the challenges in just 3 years of service. We have and will continue to prioritize and address the most critical areas in order to achieve compliance in this area.

CONTROL/FRAUD RISK ASSESSMENT ACTIVITIES

Finding 07-3

The Office of State Treasurer does not have a system in place to identify control weaknesses and possible instances of fraud or fraudulent activities in the Department's financial and operational areas.

The most important guidance relating to internal control is contained in *Internal Control – Integrated Framework* published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). This guidance dictates that a Control Risk Assessment including a Fraud Risk Assessment program be established and practiced to identify risks within the department's control environment including fraudulent type activities, when special circumstances arise, when changing operating environments, and for restructuring. In addition, the Office of State Treasurer does not have the necessary control activities designed/documented to ensure significant control weaknesses including fraud exposures are identified and mitigated.

Audit Recommendation and Agency Response

Recommendation:

We recommend the Office of State Treasurer:

- Establish and perform a control risk assessment including a fraud risk assessment on a recurring basis; and
- Design and document the necessary control activities to ensure that each of the significant control risks and fraud exposures identified during the risk assessment process has been adequately mitigated.

Office of State Treasurer Response:

We agree that we do not have a control risk assessment including fraud risk assessment documented in writing. It should be noted that the Treasurer's Office has prevented several attempts to defraud the state of funds through check alterations, forged checks, and wire fraud. We will document our procedures in writing.

Compliance With Legislative Intent

In our audit for the biennium ended June 30, 2007, we identified and tested the Office of State Treasurer's compliance with legislative intent for the following areas that we determined to be significant and of higher risk of noncompliance:

Legislative Intent Included In Our Audit Scope

- Proper deposit of civil filing fees (NDCC 27-05.2-03).
- Proper deposits into the Domestic Violence Prevention Fund (NDCC 14-03-22).
- Proper transfer of oil tax revenue to the permanent oil tax trust fund (NDCC 57-51.1-07.2).
- Proper allocation of investment income earned on the agricultural commodity assessment funds and Veterans Postwar Trust Fund (NDCC 4-24-09 and NDCC 37-14-14).
- Proper distribution of mineral lease royalties to counties (NDCC 15.1-27-25).
- Proper payments in lieu of taxes on carbon dioxide pipeline property (NDCC 57-06-17.2).
- Proper deposits into the Court Facilities Improvement Fund and Indigent Defense Administrative Fund (NDCC 29-26-22).
- Proper transfer of funds into the Ethanol Production Incentive Fund (NDCC 39-04-39).
- Proper transfers made from the General Fund to the Budget Stabilization Fund (NDCC 54-27.2-02).
- Proper deposit of oil and gas production tax and oil extraction tax into the Oil and Gas Research Fund (NDCC 57-51.1-07.3).
- Compliance with appropriations (Chapter 5 of the 2005 Session Laws).
- Compliance with OMB's Purchasing Procedures Manual.
- Travel-related expenditures made in accordance with OMB Policy and state statute.
- Proper use of outside bank accounts, petty cash funds, and proper authority for investments outside the Bank of North Dakota.
- Adequate blanket bond coverage of employees (NDCC 26.1-21-08).
- Compliance with payroll related laws including statutory salaries for applicable elected and appointed positions, and certification of payroll.
- Proper distributions from the following funds:
 - Highway Tax Distribution Fund (NDCC 20.1-02-16.6 and 54-27-19);
 - State Aid Distribution Fund (NDCC 57-39.2-26.1);

- Coal Severance Tax Distribution Fund (NDCC 57-62-02 and NDCC 57-61-01.5);
- Cigarette Tax Distribution Fund (NDCC 57-36-31);
- Oil and Gas Gross Production Tax Distribution Fund (NDCC 57-51-15);
- Township Road and Bridge Fund (NDCC 54-27-19.1);
- Coal Conversion Tax Trust Fund (NDCC 57-60-14 and 57-60-15);
- Oil Extraction Tax Development Trust Fund (NDCC 57-51.1-07);
- Estate Tax Distribution Fund (NDCC 57-37.1-08);
- Federal Tax Replacement Fund (NDCC 21-06-10);
- Senior Citizens Services and Program Fund (NDCC 57-15-56); and
- Taylor Grazing Distribution (NDCC 15.1-27-24).
- Distributions from the following funds in accordance with amounts certified by the State Tax Commission:
 - Financial Institutions Tax Distribution Fund (NDCC 57-35.3-09);
 - Telecommunication Carriers Tax Fund (NDCC 57-34-05);
 - Transmission Line Tax Distribution Fund (NDCC 57-33.1-08);
 - City Lodging Tax Suspense Fund (NDCC 57-01-02.1);
 - City Sales Tax Suspense Fund (NDCC 57-01-02.1);
 - City Restaurant and Lodging Tax Suspense Fund (NDCC 57-01-02.1); and
 - Air Transportation Fund (NDCC 57-32-04).

The criteria used to evaluate legislative intent are the laws as published in the *North Dakota Century Code* and the *North Dakota Session Laws*.

Government Auditing Standards requires auditors to report all instances of fraud and illegal acts unless they are inconsequential within the context of the audit objectives. Further, auditors are required to report significant violations of provisions of contracts or grant agreements, and significant abuse that have occurred or are likely to have occurred.

The results of our tests disclosed three instances of noncompliance that are required to be reported under *Government Auditing Standards*. These findings are described below. Other than those findings, we concluded there was compliance with the legislative intent identified above. We also noted certain inconsequential instances of noncompliance that we have reported to management of the Office of State Treasurer in a management letter dated April 30, 2008.

COAL SEVERANCE TAX DISTRIBUTION

Finding 07-4

The monthly distribution of coal severance taxes made in November 2006 was incorrect.

The Office of State Treasurer did not properly distribute amounts between coal producing and non-coal producing counties when any portion of the latter county lies within 15 miles of the tipple (the initial place where the coal is unloaded after being severed from the mine). NDCC section 57-62-02 limits payments to those non-coal producing counties by stating that revenue derived from the production exceeding 3.4 million tons in a calendar year is to be allocated entirely to the coal producing county. The distribution completed in November 2006 was made to a non-coal producing county even though the production limitation had been met.

As a result of the error noted, incorrect amounts were distributed to seven school districts and two counties. The school districts received incorrect amounts, ranging from an underpayment of \$2,758 to an overpayment of \$2,788. Morton County received more than it should have and Oliver County received less than it should have by approximately \$2,159.

The Office of State Treasurer corrected the distribution error in the March 2007 distribution.

Audit Recommendation and Agency Response

Recommendation:

We recommend the Office of State Treasurer monitor the production and apply the proper production limitation for counties and schools subject to tipple when calculating the coal severance tax distributions in accordance with NDCC section 57-62-02.

Office of State Treasurer Response:

We agree that the cap was exceeded. We will no longer rely on the Tax Department to notify us when the cap is met. We will now take the individual monthly amounts certified to us by the Tax Department and total them ourselves to ensure the cap is not exceeded in the future.

OIL AND GAS TAX DISTRIBUTION

The monthly distribution of oil and gas production taxes made in November 2006 was incorrect.

The Office of State Treasurer did not calculate the per capita limitation on an annual basis. Subsection 3 of section 57-51-15 of the North Dakota Century Code (NDCC) limits the amount of oil and gas production tax distributed to cities to \$500 per capita. However, in determining the population for any city in which total employment increases by more than 200% seasonally due to tourism, a special calculation is necessary. The only city in North Dakota affected by this special calculation is Medora. The calculation of the population starts with the last official federal decennial census and adds numbers based on seasonal employees and visitors. The last time the Office of State Treasurer updated the population number used in determining the per capita limitation was 1998. The number should be calculated annually based on the employment and visitor information for the prior year.

During the current audit we tested fiscal year 2007. Fiscal years 2005 and 2006 were tested during the previous audit. The Office of State Treasurer did not correct the overpayments made to Medora noted in the previous audit and during the current audit an additional overpayment was noted. The total combined overpayment to Medora (underpayment to Billings County) for fiscal years 2005, 2006, and 2007 was \$27,708.

Audit Recommendation and Agency Response

Recommendation:

We recommend that the Office of State Treasurer:

- 1) Compute Medora's population on an annual basis for purposes of determining the per capita limitation; and
- 2) Work with Billings County and the city of Medora to correct the overpayments made to Medora for fiscal years 2005, 2006, and 2007.

Office of State Treasurer Response:

We agree that the cap was exceeded. We will ensure audit findings are addressed and corrections made in a timely manner. Corrections for the errors were completed in March 2008. The 2007 legislature removed the \$500 per resident cap from all cities, thus the calculation to increase Medora's population is no longer necessary.

ESTATE TAX DISTRIBUTION

Finding 07-6

The office of State Treasurer is responsible for the distribution of estate taxes in accordance with North Dakota Century Code (NDCC) section 57-37.1-08. The following instances of noncompliance were noted.

The program which calculates quarterly tax distributions for estates was programmed to use the mill levy for the year of death rather than the mill levy for the calendar year preceeding death. NDCC section 57-37.1-08 requires that if any part of the decedent's property at the time of the decedent's death had a legal situs within the limits of the city, the share of the taxed based on such property must be divided by the Office of the State Treasurer between the city and county in proportion to their respective mill levies, except school levies, for the calendar year preceeding the year of death. This error appears to date back to when the program was originally written.

The Office of the State Treasurer has not been collecting overpayments of estate taxes that have been refunded to the estate of the decedent in a timely manner. Instead, the Office of State Treasurer is offsetting the amounts of refunds paid back to estates against future estate tax distributions to those counties and cities. In certain instances, offsetting the refunds against future distributions resulted in the Office of the State Treasurer still having amounts due from the cities or counties dating back into the early 1990's. NDCC section 57-37.1-08 requires that if an estate overpays the estate taxes due to the state, the overpayment must be repaid back to the estate out of any undistributed estate taxes by the Office of State Treasurer at the order of the Office of State Tax Commissioner. The Office of State Treasurer shall present and file with the appropriate county treasurers and city auditors a verified claim of such overpayment accompanied by a copy of the order of the Office of State Tax Commissioner for such refund and the county treasurer and city auditors shall pay such claim to the Office of State Treasurer.

The Office of State Treasurer incorrectly entered the mill levy rates, which are certified by the Office of State Tax Commissioner, into the estate tax distribution system. Errors included mill levy rates entered for the same city in two different counties, mill levy rates for Nelson County and all cities for Nelson County were ommitted, and mill levy rates for a number of counties and cities were entered incorrectly.

The Office of State Treasurer incorrectly calculated the amount of interest due to an estate as a result of an overpayment of estate taxes by the estate. NDCC section 57-37.1-08 requires any overpayment to be repaid must bear interest at the Bank of North Dakota's money market demand account rate on the date of the

Office of State Tax Commissioner's order to the Office of State Treasurer. Interest is to be computed from the time the tax was paid until the overpayment is repaid. Any interest owed by the state must be paid by the Office of State Treasurer.

Audit Recommendation
and Agency Response

Recommendation:

We recommend that the Office of State Treasurer:

- 1) Distribute estate tax payments to cities and counties based on mill levy rates from the calendar year preceding death;
- 2) Require cities and counties to pay overpayments of estate taxes back to the Office of State Treasurer;
- 3) Input the proper mill levy rates as certified by the Office of State Tax Commissioner into the estate tax distribution system;
- 4) Calculate interest due to estates in accordance with NDCC section 57-37.1-08; and
- 5) Consult with the Office of the Attorney General regarding the proper remedy for the erroneous payments made to cities and counties.

Office of State Treasurer Response:

We agree with the finding and have already completed the programming for the calculation of estates to use the mill levies for the year proceeding death. We have asked for an attorney general's opinion regarding the fact that for the past 30 years estates have been calculated using mill levies from the date of death.

The current estate program was not created to handle the repayment of overpayments and thus our administration as well as all prior administration's had been using the recovery method noted in the finding above. We are in the process of rewriting the estate program and will have the ability to handle the immediate recovery of estate overpayments within that system. We will request the receipt of all current receivables and track these items manually until the new system is in place.

We have made the correction to the mill levy rates and also verified that no estate payments were made in the effected counties using the incorrect rates. We have implemented new verification procedures to ensure that when mill levies are updated they are input correctly.

We will review each estate that contains multiple payments and adjustments to ensure the proper interest rate calculation is made.

Operations

This audit did not identify areas of the Office of State Treasurer's operations where we determined it was practical at this time to help to improve efficiency or effectiveness.

Prior Recommendations Not Implemented

Prior recommendations have been implemented with the exception of the following:

COAL SEVERANCE TAX DISTRIBUTION

Finding 05-5

Background

The monthly distributions of coal severance taxes were made incorrectly. There were three different types of errors that resulted in the improper distribution amounts. Distributions were made using incorrect average daily enrollment numbers, incorrect land assessment values, and not applying the proper production limitation in accordance with NDCC section 57-62-02. This recommendation was given in the 2003-2002 and 2005-2004 biennial agency audits.

Recommendation

We recommend the Office of State Treasurer:

- Use current average daily enrollment numbers, current land assessment values, and apply the proper production limitation for counties and schools subject to tipple when calculating the coal severance tax distributions in accordance with NDCC section 57-62-02; and
- Correct the erroneous payments made as required by NDCC section 54-11-01 subsection 18.

Status

The Office of State Treasurer did use the proper average daily enrollment numbers, current land assessment values, and corrected the erroneous payments made during the previous audit. However, the distribution related to the production limitation for counties and schools subject to tipple was not made in accordance with NDCC section 57-62-02. See new recommendation on page 20.

OIL AND GAS PRODUCTION TAX DISTRIBUTION

Finding 05-6

Background

The Office of State Treasurer has not properly calculated the per capita limitation on oil and gas production taxes for the city of Medora. This recommendation was given in the 2003-2002 and 2005-2004 biennial agency audits.

Recommendation

We recommend the Office of State Treasurer:

- Compute Medora's population on an annual basis for purposes of determining the per capita limitation;
- Work with Billings County and the city of Medora to correct the distribution errors made;
- Ensure that programming changes made to the distribution system are made properly; and
- Correct the erroneous payments made as required by NDCC section 54-11-01, subsection 18.

Status

The Office of State Treasurer did ensure that programming changes made to the distribution system were proper. However, as of June 30, 2007, the per capita limitation was not computed, Billings County and Medora were not contacted about the distribution errors identified in the previous audit, and the erroneous payments made were not corrected as required by NDCC section 54-11-01, subsection 18. See new recommendation on page 21.

Management Letter (Informal Recommendations)

April 30, 2008

The Honorable Kelly Schmidt
State Treasurer
Office of State Treasurer
600 E. Boulevard Avenue
Bismarck, North Dakota 58505

Dear Treasurer Schmidt:

We have performed an audit of the Office of State Treasurer for the biennium ended June 30, 2007, and have issued a report thereon. As part of our audit, we gained an understanding of the Office of State Treasurer's internal control structure to the extent we considered necessary to achieve our audit objectives. We also performed tests of compliance as described in the same report.

Our audit procedures are designed primarily to enable us to report on our objectives including those related to internal control and compliance with laws and regulations and may not bring to light all weaknesses in systems and procedures or noncompliance with laws and regulations which may exist. We aim, however, to use our knowledge of your organization gained during our work to make comments and suggestions which we hope will be useful to you.

In connection with the audit, gaining an understanding of the internal control structure, and tests of compliance with laws and regulations referred to above, we noted certain conditions we did not consider reportable within the context of your audit report. These conditions relate to areas of general business practice or control issues that have no significant bearing on the administration of federal funds. We do, however, want to present our recommendations to you for your consideration and whatever follow-up action you consider appropriate. During the next audit we will determine if these recommendations have been implemented, and if not, we will reconsider their status as non-reportable conditions.

The following present our informal recommendations.

LEGISLATIVE INTENT

Informal Recommendation 07-1: We recommend the Office of State Treasurer distribute funds received from the Flood Control program to the counties on a timely basis or when there is a reasonable amount of money in the fund that needs to be distributed.

Informal Recommendation 07-2: We recommend the Office of State Treasurer implement internal controls to ensure:

- The proper amount is deposited into the Oil and Gas Research Fund (247) as stated in NDCC section 57-51.1-07.3 and not deposit any amounts in excess of the maximum transfer amount as mandated by NDCC; and
- Fees are deposited into the correct fund when initially received, and deposit the first \$750,000 into the Indigent Defense Administration Fund (282) and the next \$460,000 into the Court Facilities Improvement and Maintenance Fund (279) in accordance with NDCC section 29-26-22.

Informal Recommendation 07-3: We recommend the Office of State Treasurer update and clarify the following sections of NDCC:

- NDCC section 53-06.1-12 pertaining to gaming taxes;
- NDCC sections 57-51.1-07.2 and 57-51.1-07.3 pertaining to the oil and gas tax distribution; and
- NDCC section 54-27-19 related to the highway tax distribution.

Informal Recommendation 07-4: We recommend the Office of State Treasurer implement controls to ensure that the amounts certified by the Office of State Tax Commissioner for deposit into the Senior Citizens Program Services Fund (255) are deposited in accordance with NDCC section 57-39.2-26.2.

Informal Recommendation 07-5: We recommend the Office of State Treasurer distribute funds deposited by the Office of State Tax Commissioner in the Air Transportation fund (494) within 90 days of deposit in accordance with NDCC section 57-32-04.

PERVASIVE CONTROLS

Informal Recommendation 07-6: We recommend the Office of State Treasurer develop a code of ethics and code of business conduct and ensure that employees adhere to the policy.

Management of the Office of State Treasurer agreed with these recommendations.

I encourage you to call myself or an audit manager at 328-2243 if you have any questions about the implementation of recommendations included in your audit report or this letter.

Sincerely,

Michael W. Schmitcke, CPA
Auditor in-charge